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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 006623

SIPDIS

STATE FOR E, EB/IFD, EUR/SE
TREASURY FOR OASIA - MMILLS AND JLEICHTER
NSC FOR MCKIBBEN AND BRYZA

E.O. 12958: DECL: 10/21/2008
TAGS: EFIN TU
SUBJECT: MEETINGS WITH GOT AND IMF ON SIXTH REVIEW, BUDGET

REF: A. ANKARA 6448
¶B. ANKARA 6442

Classified by Acting Economic Counselor Andrew Snow for reasons 1.5 (b) and (d).

¶1. (C) Summary: The GOT needs to take several actions--mostly submission of legislation to parliament--before signature of a Letter of Intent, expected by early next week. Additional actions will be needed before the IMF Board vote, expected mid-November. The GOT is making fiscal adjustments of 0.65 percent of GNP for the remainder of 2003, and of 2 percent of GNP for 2004 in order to meet the 6.5 percent of GNP primary surplus target for each year. Half of the 2004 adjustment stems from making permanent the temporary Special Communications Tax and Special Transaction Tax. According to the IMF Deputy ResRep Finance Minister Unakitan played an important role in convincing the Prime Minister to make concessions on the Direct Tax Reform. End Summary.

¶2. (Sbu) In a series of meetings with GOT officials and IMF Deputy Resident Representative Christoph Klingen (protect), Econoff discussed the IMF Sixth Review and the Budget submitted to parliament October 17.

IMF State of Play:
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¶3. (Sbu) The Fund Mission left October 15 without a Letter of Intent and with a series of actions the GOT needs to take before a Letter of Intent is signed, with additional actions needed by the date of the Board Vote. According to Klingen, before the Letter of Intent, the GOT needs to:

--Submit budget to parliament in line with IMF agreement (done but IMF reviewing details)

--Submit BRSA and Financial Mgmt and Control law to parliament (not sure if done but about to be, if not)

--Submit legislation creating additional incentives for SEE employees who retire before year-end.

--Approve in Council of Ministers the Turk Telekom privatization plan

--Announce the clean-up plan for Imar Bank

Before the IMF Board vote, the GOT needs to:

--Approve in Council of Ministers the Direct Tax reform

--Pass BRSA and Financial Mgmt and Control laws

Klingen was not aware of any particular problems with these issues, but the GOT has a lot of work to do. On Pamuk Bank, Klingen believed it was just a problem of getting the Turkish Treasury to focus on the unpleasant task of transferring funds to BRSA.

¶4. (C) On the Direct Tax Reform, Klingen said that Finance

Minister Unakitan had played a key role, by joining forces with Babacan in convincing the Prime Minister to accept a significantly-watered down version of the geographic tax incentives. According to Klingen, the incentives would only apply in the poorest regions, whereas the P.M. had earlier spoken of a much larger area. The chief incentive is that employers will not have to pay Social Security premia for new employees, and that new employees will also get a tax exemption. Since the poorer regions concerned account for a negligible portion of current tax revenue, and few new jobs are being created there, the IMF is not too concerned about granting these modest incentives.

¶5. (Sbu) On the Free Trade Zones, Klingen confirmed that the GOT agreed to eliminate the personal income tax exemption on employees of newly-established companies in the FTZ's, and that exisiting manufacturing companies' employees would lose their personal income tax exemption in five years.

¶6. (Sbu) Klingen said the Fund had no issues with monetary policy. Turkey had easily exceeded all monetary targets. The only one that was a bit "tight" was base money but that this was understandable because of the reverse currency substitution in recent months. Klingen reiterated earlier Fund staff comments about not wanting the disbursements under the U.S. loan to be used to repay domestic debt, since these inflows would have to be sterilized, exacerbating losses at the Central Bank. Klingen was not concerned about the Current Account Deficit (Former Economy Minister Dervis had raised concerns about the Current Account in a speech last week). Klingen felt that Turkey appeared to have adequate access to financing, and it's exports remain strong despite the currency appreciation.

Budget:
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¶7. (C) Finance Ministry budget official Ahmet Kesik (protect), State Planning Organization Deputy Undersecretary Birol Aydemir (protect) and Klingen, in separate meetings, provided additional details on the fiscal situation. To achieve the 6.5 percent primary surplus target for 2004, the GOT has agreed with the IMF to take adjustment measures amounting to TL 8.4 Quadrillion, about 2 percent of GNP. According to Aydemir, about TL 4.5 Quadrillion of this adjustment derives from making permanent the "temporary" Special Communications Taxes and Special Transaction Taxes. Much more modest amounts were derived from the more controversial measures on the Special Consumption tax rates for autos, alcohol and tobacco: TL 170 m Trillion from alcohol and tobacco and TL 200 Trillion from autos. The rates for the Special Consumption Tax on autos were increased only slightly at the low end, and substantially increased for luxury vehicles. On alcohol, Aydemir claimed that the rates were not increased. Instead, the GOT set a floor for a minimum tax per unit of each product. The reason, according to Aydemir, is that imports were coming in at very low prices. Since the taxes are calculated as a percentage of the price, the more cheaply priced imports were paying a lower tax per unit than local producers.

¶8. (Sbu) Most of the adjustment came from revenue rather than spending measures. According to Aydemir, the only spending measure was to hold Social Security Spending constant in nominal terms. Broadly speaking, all other categories were allowed to increase in line with projected inflation, such that non-interest expenditure remained at the same percentage of GNP in 2003 and 2004. Kesik provided the exact percentages projected: 22.6 percent of GNP (TL 94 Quadrillion) in 2004 and 22.9 percent (TL 82 Quadrillion) in ¶2003. Kesik noted the wage restraint: a 13.8 percent increse for public sector workers, roughly in line with inflation. The public sector wage bill will remain 8.4 percent of GNP in 2004, as in 2003. Kesik contrasted this discipline on wages with the exorbitant, fiscally-damaging wage increases under the Ecevit Government. According to Kesik, no significant fiscal savings will be realized from the reduction in SEE employees until 2005, since there will be severance payments in 2004 and many retirements take place near the end of the year.

¶9. (C) According to Kesik, the 2003 fiscal adjustment is 0.65 percent of GNP or TL 2.33 Trillion. The most significant items were: 0.28 percent from cuts in investment spending, 0.16 percent from restrictions on expenditures to be financed from special revenues (sic), .07 percent from tobacco and alcohol, and .06 percent from the Special Transaction Tax and Education Levies. Klingen confirmed that the GOT now really does seem committed to the 6.5 percent primary surplus target for both 2003 and 2004. In the negotiations, the GOT

officials did not try to push back on the overall target, the necessity of which they seemed to recognize. Aydemir pointed out that both in 2003 and 2004, the 6.5 percent primary surplus breaks down as 5 percent from the Central Government, and 1.5 percent from the rest of the public sector: SEE's, municipalities, Social Security funds and other special funds. Aydemir saw little risk of not meeting the 2003 primary surplus target. For 2004, the main risk area continues to be Social Security. In his view, the IMF reform of Social Security is not working well.

Monthly Primary Surplus Data:
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¶10. (Sbu) According to Kesik, the August primary surplus was TL 5.5 Quadrillion, versus an expectation of TL 4.5 Quadrillion. Klingen, on the other hand, said the IMF still does not have a final August primary surplus number, according to the Fund's definition. Klingen explained that although the Central Government reports its data fairly quickly, there is a huge lag in getting detailed data for the consolidated public sector, including the SEE's and the Social Security Funds. Nevertheless, Klingen is fairly confident that the target was missed, but only by about TL 200-300 Trillion. Kesik and Treasury official Tulay Arslan stressed the seasonality in the fiscal data, with tax payments inflating the May, August, and November data. The seasonality can be seen in the preliminary September primary surplus of only TL 1.2 Quadrillion. Klingen said the expectation had been around TL 1.5 Quadrillion.

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